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ECONOMIC AND MONETARY UNION IN EUROPE AND GLOBAL ECONOMIC COOPERATION

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1 Professor of Economics, University of Copenhagen; Associate Senior Research Fellow, Centre for European Policy Studies, Brussels. - I have been guided, in preparing this paper, by the terms of reference supplied to authors by the IAI in June 1990. The present paper abstracts from any assessment of the effects of economic reforms in Eastern Europe (apart from German unification) and from the upheaval in the Soviet economy since these subjects are covered in the paper by Professor Boffito.

Introduction and summary.

As observers from the United States and Japan – and other non–European industrial countries – watch economic and political trends in the European Communities, conflicting sentiments are voiced. On the one hand it is difficult not to be impressed with both the vigour of the recovery of the EC economies over the past five years and the progress already made in European integration. On the other hand fears are expressed that the member states and other European countries anxious to join the process will become totally absorbed by their regional concerns. Such fears may appear to be in part justified by EC actions and discussions on trade and macroeconomic coordination with the other main actors in the world economy. The purpose of the present paper is to review whether these fears are realistic in the context of the outlook for the main regions in the global economy in the 1990s. Is there a risk that the interests of others are overlooked as the EC completes its Single Market, moves towards Economic and Monetary Union and absorbs new members in the course of the 1990s ? Is there a conflict between renewed European emphasis on regionalism and a harmonions evolutions of relations with the United States and Japan ?

These are large and complex issues to which only superficial answers can be given in a short paper. Nevertheless, it does seem possible, to the present author, to argue that there is no basic conflict between regionalism in Europe and globalism and that the former, when constructively interpreted, is more likely to lead to improvements also in the global trade and macroeconomic relations than the opposite. May be the greatest assurance to critical outside (or European) obesevers lies in the potential of a failure to manage the global relations in a satisfactory way to upset also the progress of the EC economies and the European integration process.

The rest of the paper is in two main sections. The first and longer one sets out some of the main elements in the outlook for imbalances and sources of tensions in the world economy in the

1990s and asks what contributions the completion of the Single Market and the move towards Economic and Monetary Union can make to this outlook and to facilitating global economic management. The second section reviews recent experience with monetary and exchange-rate cooperation in the G5/7 in order to draw some lessons for a future system in which Europe will emerge as a more unified actor. A final section draws some tentative conclusions.

Trade and current account imbalances in the 1990s.

Major tensions in the global trading and payments system have emerged in the 1980s. As the United States economy took the lead out of the 1980–82 international recession, a massive trade and current account deficit opened up in the US balance of payments as the combined results of relatively faster growth of domestic demand in the United States and the dollar appreciation up to early 1985. This process was mirrored by large surpluses in Japan and Germany, see Table 1. These imbalances have proved to be so persistent – and so resistent to the subsequent correction of both of the factors which product them – that the impression of their permanence has become hard to modify. Yet there are signs that these imbalances have already by 1990 been sharply reduced and that the prospects for a fairly complete adjustment over the next few years are excellent. These recent developments – far more promising than the dire predictions commonly heard a few years ago of a hard landing for the dollar, a serious US recession and a relapse into protectionism by all major parties – should prompt reflection as to how the major actors in the world economy can cooperate in the international system to preserve the emerging restoration of balance rather than renewed efforts to apportion blame for a past which has turned out better than could have been expected.

In the United States external account improvements have been visible since about 1987 when the deficit peaked. The appreciation of the dollar up to 1985 was so large, and the devastating effect on the international competitiveness of major sectors of the US economy so important, that it should not, in retrospect, be surprising that the response to subsequent improvements in competitiveness, presently to about the level of 1980, was initially delayed. Both US firms and their international competitors adopted initially a wait-and-see attitude to developments in the exchange markets. They wanted to be more certain of the permanence of the reversal of the squeeze on profit margins in the US market before reacting to the renewed incentives by investing and, in particular, by stepping up export activity. These delays are no doubt the main explanation why the US trade deficit has not been reduced to near-equilibrium where it was in 1980-81 at approximately the same level of the real exchange rate (competitiveness). Substantial further improvements in the US trade performance should be in store over the next few years.

Most macroeconomic models take a more pessimistic view; they typically forecast a US current account deficit stabilising around \$ 100 billion annually in the first half of the 1990's, taking into account a steady, though so far surprisingly slow, rise in US payments of interest on the growing net debt of the United States to the rest of the world. Such a forecast would be temporarily improved upon during a US recession, since it is based on the assumption of growth in the US and in its main trading partners close to trend growth in capacity output. The contention here is, in line with a recent analysis by Marris (1990), that a further reduction in the US deficit is a more likely outcome. Even if the deficit were to stay around \$ 100 billion, that would be less than 2 per cent of US GNP as against 4 per cent in 1987, not to speak of the 6 per cent which, according to a number of forecast of the 1985-86 period, would have been observable around 1990 in the absence of exchange-rate adjustment. Despite the absence of any major action up to now on the US budget deficit, the process of external ajustment <u>has</u> made considerable progress. It would have been preferable if more had been done to reduce the budget deficit while the economy was still strong up to 1989, and it will be important to implement the deficit reduction package adopted by the US Congress in October 1990 much more rigorously than past similar eforts. A or to develop the EMS into a more cohesive structure, ultimately an EMU which would at least make intra-European imbalances less of a constraint, though that is not unimportant as will be argued below. Rather, the new and paradoxially stabilizing influence on both the European and global imbalances has come from events unforeseen until recently: the unification of Germany (German Economic Monetary and Social Union, GEMSU), preceded by large-scale emigration to the West. However positive an assessment one may have of the political aspects of GEMSU, it should not be overlooked that in straight economic terms it would have been difficult to design a more counstructive impulse to the international and the European economy.

Quantitative evaluations of the impact of GEMSU are still in short supply and not necessarily reliable. Yet some main points seem fairly robust in early efforts at quantification by the International Monetary Fund and other sources: The former GDR may be expected to increase its net imports by $ 20 billion in the first year or two after GEMSU, rising to twice that amount in each of the subsequent 3-4 years and then tapering off slowly, as output in the former GDR catches up with domestic demand in that area. The speed with which that tapering off occurs depends on the extent to which the new market economy is able to catch up with productivity levels in West Germany. Even on the most optimistic assumptions in this respect, the former GDR is bound to remain a source of net demand for imports well beyond the year 2000. Assumptions then have to be made as to how this additional net demand will be satisfied. If that could occur largely from the other part of Germany without leading to any significant inflation and/or real appreciation of the DM, the effects on other economies in Europe or elsewhere will be modest and indirect. The more the former GDR turns out to have a long-run demand pattern similar to those of smaller economies in Europe such as Belgium or Denmark, which cover only app. 20 per cent of their import demands in Germany, the more directly the impact of the net demand stimulus from the former GDR will be felt elsewhere.

Estimates of the likely impact on the current account for a unified Germany range widely because of this uncertainty of the geographical distribution of demand, but it appears probable that the deterioration would for a period of 3–4 years be in the order of 1 1/2 – 2 per cent of collective German GDP. If so the current surplus would roughly disappear during this transition. The outcome for other European countries is sensitive to the assumptions made about their policy responses. A modest improvement in their joint current account seems likely, but insufficient to offset the swing in Germany's current account. The implication is that the latter would be close to zero while a collective deficit for the EC would open up, assuming the real effective exchange rates of participants to appreciate slightly from present levels. This is a well-designed recipe for better balance between the three main industrialized areas; the United States, Japan and the EC should all have imbalances within 1 per cent of GDP in the 1992–94 period and probably beyond. Taking this longer perspective of the international economy, the conditions for less conflictual trade and monetary relationships than in the 1970s and 1980s should be propitious.

This secnario is optimistic in the sense that it is not difficult to see how a worse outcome could come about. The injection of additional demand through the German economy, already operating close to short-run capacity limits, is sufficiently substantial to give a further push to inflation in Germany and, in a more subdued form, elsewhere in Europe. The shift in the savings investment balance in Germany, coinciding with some slippage in the household savings ratio in Japan, will raise interest rates beyond what is warranted by the increase in inflation. To the extent that this has not already been anticipated and incorporated in interest rates, currency movements could be triggered beyond what is justified by the prospect of persistent surpluses in Germany. Unless macroeconomic coordination, centered on some understanding on permissible exchange-rate fluctuations, rises to this challenge, cyclically-generated trade and payments imbalances could reappear and protectionist pressures intensify in the regions which experience a deterioration of competitiveness.

Risks are never absent in the international economy. But the 1990s look more reassuring than could have been expected both because of endogeneous forces of adjustment (and broadly sensible policy reactions in the second half of the 1980s) and because of the impact of the truly exogenous shock of GEMSU. Having asked for much of the past decade for more ambitious growth-oriented policies in Germany, the United States and the non-German EC-countries can hardly claim that no risks are being taken in German economic policy. The present concerns are rather of the opposite nature: that too much strain is put on resources and that the shock to the global savings-investment balance is excessive, making some tightening of fiscal policy desirable. In any case, Germany will have less of a motive than at any other time in the past two decades - the brief period of a current account deficit in 1980-81 being a temporary exception - to hide behind her EC commitments when discussing global economic adjustment and to refer to slow demographic growth and other supply constraints in general. By rising rapidly to the challenge of GEMSU the German economy will for a good part of the 1990s take on the locomotive role in the EC and beyond.

The emergence of a German current account in approximate balance and the rest of the EC in moderate deficit implies a favourable starting point for international trade and macroeconmic coordination in the 1990s. A lack of perception as to the extent to which the baseline is now favourable may be a significant element behind the low threshold of irritability observable in trade negotiations and in efforts at policy coordination. Policy-makers continue to regard international imbalances as permanent and intractable, as the evidence is already coming in that they are not, and they allow conflicts over issues which, in a macroeconomic sense, are of much smaller significance to escalate, as is currently the case with respect to the completion of the Uruguay Round. As they look at the completion of the Single Market and the move to EMU policy-makers in the United States and Japan see them as initiatives that might further disadvantage the situation of their producers and other interests from a point where the playing field is already tilted in favour of the EC. How can this picture be reconciled with the fairly harmonious baseline secnario outlined above which did not take into account explicitly the effects of the Single Market and EMU, likely to become fully observable by the mid-1990s ? The following section attempts a macroeconomic assessment, leaving some implications for the process of coordination for the subsequent section.

Macroeconomic effects of the Single Market and of EMU.

Though now close to 3 years old the analysis by the EC Commission (1988) of the likely effects of the completion of the Single Market must still be the starting point. The main conclusions regarding the medium-term effects, i.e. about five years after implementation, are summarized in Table 2. Real output may be expected to be some 4 1/2 per cent higher than in the absense of market integration, the level of producer prices, 6 per cent lower. These estimates are subject to important uncertainty, probably going beyond the ranges indicated in the table; they are rough orders of magnitude which may be thought of as applying to the mid-1990s, assuming - as appears probable - that most of the significant elements in the 1992 programme will have been implemented by the end of that year.

Most other empirical work on the Single Market, done independently or in reaction to the EC Commission's pioneering study, argued that the gains were more likely to be smaller than larger. But recently, arguments have been advanced that, at least if one also takes the prospect of significant progress towards EMU into account, any presumed bias could well be in the opposite direction. EMU was not yet on the near-term agenda when the 1988-study was done and it adds some modest calculable efficiency gains to the list through the elimination of all transactions and information costs related to residual exchange-rate variability and uncertainty in Europe. More significantly, a single monetary area will consolidate the gains arising from greater competition and transparency, since the incentives to retain elements of price discrimination between national markets would be reduced much further. In responses to questionaires large European enterprises have offered surprisingly high estimates of the cost savings they could make, if the EC were to adopt a single currency (1/2–1 per cent of their turnover). EMU would also make it more likely that the gains from intensified competition in financial services, which, as shown in Table 2, constitute an important part of the gains from the Single Market, would be achieved. Furthermore, some economists have argued that the gains from the Single Market + EMU would not just result in a once-and-for-all lift in the level of real output and decline in the price level (or, more precisely, a temporary rise over the five-year adjustment period in the annual growth rate of output by 1 percentage point, and a decelaration of prices by 1–1 1/2 per cent per year over this horizon), but in a more permanent rise in the rate of output growth, see EC Commission (1990), largely through the reduction of investment risk.

These recent arguments related to the additional gains from monetary integration suggest that the early calculations were not too optimistic, but rather the opposite. Although much of the 1992-programme has now been set into motion and significant advances in monetary integration are observable, it may therefore be legitimate to take the gains calculated in the 1988-study as an indication of what could still be attainable between now and the mid-1990s. If so, what would be implications for the trade and current account of the EC ?

There are elements of both trade creation and diversion in such a scenario. The former is inherent in the faster growth of the economies participating in the integration of goods and services markets. In the past, for every 1 per cent increase in EC output, imports from the rest of the world tended on average to rise by 1 1/2 per cent; the implication of a 4 1/2 per cent lift in the EC's, income is to leave imports from non-EC countries nearly 7 per cent higher than they would otherwise have been. But the EC Commission (1988) estimates that trade diversion through the completion of the Single Market – EC-producers replacing outsiders as the barriers to trade are lowered or eliminated in Europe, but not globally, and European prices decelerate – could amount to a little more than 9 per cent of EC imports from the rest of the world. Assuming other determinants of trade flows to be unchanged, the average effect for outsides would on these calculations be to leave their exports to the EC 2 1/2 per cent lower than they would otherwise have been.[3] How this would be distributed among the United States, Japan and other trading partners requires much detailed analysis, but in the absence of compensating measures both of the other main industrialized areas, as well as European countries not participating in the Single Market, would experience some deterioration of their respective trade and payments balances with the EC. However, since trade between the main trading areas is small – app. 12 per cent of GNP for all three – the total impact of the net trade diversion translates into an improvement of the EC's current account of less than 1 per cent of its GNP and a deterioration in the US and Japanese current accounts of at most 1/2 per cent of GNP for each.

If this shift is seen as undesirable, on the background of the baseline scenario outlined in the previous section, because it might just put the EC back into a small current surplus and to enlarge the remaining US deficit, there are – as with other efforts at containing imbalances – various combinations of two adjustment mechanisms that could be relied upon. Either the EC–countries can take measures to expand their domestic demand relative to output at unchanged exchange rates, or they can shift demand away from home output by allowing their currency (or

3 Some observers, e.g. Shigehara (1990), have argued that net trade diversion may be stronger. Much of the effect of the Single Market arises from economies of scale which imply drastic reductions in the number of producers and one may legitimately question whether EC governments will prove fully prepared to face up to the temporary unemployment costs of rapid reorganization without additional protectionist devices in the form of "voluntary" export restraints on non–EC producers, minimum local content provisions etc. The recent EC record is not fully reassuring in this respect.

currencies) to appreciate. What they will in fact choose to do, if anything explicit, will depend on (1) the macroeconomic environment at the time a need for correction of the external balance is perceived, (2) the degree of cohesion of the EC, and in particular its capacity to influence aggregate budgetary policy in the EC, and (3) the reactions of the other main actors.

This scenario of a renewed, though modest, swing towards surplus in the EC's current account as a result of the boost to competitiveness in Europe, resulting from successful completion of the Single Market and moves towards EMU, is interesting less for the dangers posed by the scenario itself, which should be manageable, than for the requirements if imposes on the EC as a participant in international policy coordination. As the United States and Japan watch the EC conduct trade policy and develop considerable momentum in its internal integration in several fields they will expect the EC to be able to address also the external macroeconomic implications of its own evolution and to take a view on the proper size of its own current account. The Europeans have in the 1980s often expressed their views – mainly individually – on the objective of reducing the US deficit and the Japanese surplus while having no common view on their own collective position. The latter was barely a reality to them, given the major national differences in performance, ranging from the large surplus Germany and the Benelux countries to equally large, in relative terms, deficits in Spain and the United Kingdom. In view of this diversity it was hardly possible for the Europeans to discuss what share of the counterpart to the adjustment of the US deficit they were prepared to assume.

With the baseline scenario in the previous section, some of these differences would be much reduced, while the perception of belonging to a cohesive monetary area spreads to additional EC member states. Both developments suggest that a focus on the collective current account of the EC could be desirable in the 1990s as a European contribution to maintaining balance in the international economy. An indication of readiness to aim to maintain a small and steady collective deficit throughout most og the 1990s could be a major contribution of the EC to international policy coordination. A stated non-mercantilist intention would be reassuring to the main trading partners and it could form the basis for more stable currency relationships with third currencies. It would also fit well into an increasing role for European financial markets and a European currency in the world economy in the 1990s to aim for a (small) current account dificit for the EC as a whole.

Would the EC, even if developed into an EMU with a single monetary authority, be equipped to make such a contribution to international policy coordination ? To be a major international actor requires getting one's own act together. There appears currently to be surprisingly wide agreement among EC governments that a high degree of centralization of monetary authority is desirable and feasible in the course of the coming decade, and that the priority objective of a common monetary policy should be to aim for price stability, see Thygesen (1990). This implies that the prospective European System of Central Banks (ESCB) can be expected to steer clear of obligations to intervene to stabilize the external value of the currency which could conflict with the price objective. A single European currency would continue to fluctuate in terms of the dollar and the yen; EMU is not a direct route to a global system of tightly managed exchange rates, though it could help indirectly as will be argued in the next section. But will EMU also be underpinned by a readiness on the part of member states to subject the aggregate thrust of their national budgetary policies to collective influence and to use such authority constructively in international policy coordination ?

The United States has not shown any readiness to give external considerations major weight in budgetary decision-making. As Congress has a decisive role in the latter, it would not be feasible for the US Administration to commit itself to any specific actions. European participants have some capacity to commit themselves individually, but they have no collective authority over budgetary policy; the EC budget is too small to expect any significant stabilization function from it.

Whether the EC should have some such authority is a central issue in the forthcoming negotiations in the Intergovernmental Conference (IGC) to prepare the Treaty changes necessary for EMU. The case in favour is usually put in terms of the need to contain potentially excessive budget deficits in individual member states; with an integrated capital market in the EMU, countries would be able to avoid the rising costs of rapid debt accumulation in a national financial market in the form of higher interest rates and pressure of the currency, so an EC-imposed upper limit on such behaviour is advocated by some as a necessary constraint. There is, however, another argument. The participants in EMU should endow themselves with means of influencing the aggregate thrust of budgetary policies in the member states in order to avoid putting themselves in the same position for which they have criticized the United States: to be unable to address the proper policy-mix between fiscal and monetary policy and the desirable balance between changes in domestic demand inside the EMU and movements in the exchange rate vis à vis the main third currencies.

What would be the likely outcome for international imbalances and the adjustment to them, if the EC does develop its policy-making capacity differentially, i.e. much more strongly on the monetary side with an ESCB emerging as an autonomous institution in its pursuit of price stability, while aggregate budgetary policy largely remains the outcome of the decentralized decision process in the member states ? An analogy to the tensions in the policy-mix observed in the United States in the early 1980s is not implausible: strongly expansionary budget policies – as indirect and direct taxes are reduced in high-tax countries towards a common denominator and expenditures, including transfers to the GDR in the German case, are kept less tightly in check by governments relieved of their concerns about their individual external imbalances (current-account dificits, foreign-exchange crises) – clashing with a fairly tight monetary policy. In such a scenario interest rates in the EC would rise relative to rates elsewhere and the European currency would appreciate in real terms relative to the baseline (which already implied some real appreciation relative to to-day). Both transmission channels would operate to enlarge the modest collective current account deficit.

This scenario is not the only possible one, but it does appear quite plausible. As the prospects for much smaller imbalances between the trilateral areas and less currency instability than in the 1987-90 period (not to speak of the turbulent earlier years in the 1980s) were improving and fundamentals move more closely together, the EC and the formation of a lop-sided EMU may provide a new impetus for medium-term cycles in the main exchange rates in the international system.

Is this scenario too pessimistic ? Europeans with their background of individual experiences with exchange-rate fluctuations and pains of occasional overvaluation of currencies in the past, may prove to be sensitive at an earlier stage of the process of real appreciation to the squeeze on their internationally-exposed industries than was the US political establishment, which only reacted late (in 1985) to the threats of deindustrialization and new protectionism due to the strong dollar, see the vivid account in Destler and Henning (1989). It is likely also that the pressure on the emerging ESCB to intervene to slow appreciation would arise more forcefully in Europe than it did in the United States, ideologically set against intervention at the time, despite the efforts to leave the new European institution a maximum of discretion in its implementation of the price stability objective.

The plausibility of this scenario makes the discussion in the forthcoming IGC on who has the authority to intervene and on the scope for influencing aggregate budgetary policy in EMU essential to the future role of European participants in the process of the international policy coordination. It would not be in the long-run interest of EMU to set up a system which pushed it into the same deficiencies of which Europeans have rightly been so critical of the United States.

Towards a tripolar international monetary system.

The original six EC member states were not in any significant sense aware of a need to develop a framework for monetary coordination tighter than that prevailing at the time in the global system. The articles of the Rome Treaty relating to macroeconomic policies and exchange rates are brief and bland. Their confidence in the global framework was well justified in the first decade of the EC's existence when exchange rates were fairly stable and inflation was moderate. With the break-up of the Bretton Woods system and the extension of EC-membership at the beginning of the 1970s complacency in this area became outdated.

Over the past two decades the EC countries have on three occasions taken iniatives to make their exchange-rate regime, and the policy coordination to underpin it, tighter than what prevailed in the global system. The first was the launching of the joint float, the "snake", in 1972; several important member states defected early, but the system surrived for five of them and provided useful initial experience. The second was the launching of the EMS in 1978-79 which enlarged participation, saw the participant through the turbulent early 1980's and gradually tightened itself up in increasing contrast to the global system, despite some progress in managing the latter since 1985. The third is the decision to develop the EMS into a full-scale monetary union with a single currency as the final objective.

There are interesting similarities and differences as one compares these three initiatives. The two early ones were primarily inspired by dissatisfaction with the instability of the global system The plans for EMU appear more clearly motivated by the logic of the evolution of the EMS itself in a framework of increasing capital mobility. The third effort is the first to have major implications for the global system itself, while the first two served mainly, in this context, to demonstrate that tightly managed exchange rates were not as unfeasible among countries that had only weak coordination mechanisms in other areas as was generally believed by economists and officials alike.

The Europeans clearly welcomed the efforts initiated by the US Administration in 1985 to abandon free floating and resume some focus of international policy coordintion. Anyone looking at a chart of the $/DM rate in the 1980s (Figure 1) can see that monetary authorities were far from powerless in influencing exchange rates. The Plaza Agreement of September 1985 helped to bring the dollar down rapidly, but in an orderly way, from its massively overvalued level. The Louvre Accord of February 1987 was not a European initiative, but led by the French they followed up on a US–Japanese understanding to stabilize the dollar around "current levels" within a range that was unannounced, but has since become clarified, e.g. in individual explanations collected in Funabashi (1988). To the EMS–participants stabiliztion of the dollar appeared as a useful complement to their own determination not to accept easily a repeat of their January 1987 realignment which was seen as provoked by persistent weakening of the dollar. Initially the experience was not promising, as EMS and other European central banks had to finance the US deficit in this peak year, and the policy conflict over interest rates in the autumn of 1987 did not help.

Looking back at the nearly 4 years since the Louvre Accord exchange–rate fluctuations have been heavily damped and the fears of a hard landing for the dollar at least postponed if not removed. Yet there are few illusions in Europe as to the efficiency of the G7 coordination process.[4] On two occasions within the past two years first the United States and then Japan fell compelled to put domestic considerations ahead of observance of the ground rules for stable exchange rates.

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[4] For a detailed account of the G7 experience in policy coordination in recent years, see Gomel, Saccomani and Vona (1990).

Throughout much of 1988–89 a relative rise in US interest rates, as the economy continued to boom and the budget deficit could not be reduced, pushed up the dollar and interrupted the required longer–run reduction in the external deficit. Only when the G7 openly criticized this tendency in September 1989 did a correction set in vis–à–vis the European currencies. The yen, however, weakened even against the dolar, as the Japanese authorities were delaying increases in interest rates because the Tokyo stock market was already falling. Since April 1990 the yen has again appreciated in step with tighter monetary policy, though it is still some 20 per cent below its 1989 peak vis–à–vis the DM.

Potentially more serious than these temporary interruptions in exchange–rate trends conducive to lower external imbalances is the recent weakness of the dollar. Here the direction of change is no doubt correct, but since it is the first time since the Louvre Accord that the dollar has fallen below the fairly wide range within which it was presumed to move, markets are anxiously looking for signals that the authorities of the G7 countries have not just abandonned the understanding achieved nearly 4 years earlier, but are also putting something else in its place. With the present outlook for a weaker US economy and more inflationary pressures in Germany and elsewhere in Europe, the replacement would ideally be a restatement of an exchange rate range with lower rates for the dollar and fiscal tightening in Europe to check the increase in interest rates. This is also the response advocated by the Bundesbank, while several other European policy–makers urge that there should be renewed efforts by the G7 to stabilize exchange rates prior to any fiscal adjustment, in the belief that the dollar might otherwise fall too low and that it might require a lot of time and heavy interventions to regain authority in the markets. This second view has been gaining ground in European, including German, industry in recent months.

The current situation seems not untypical of the medium–term scenario facing the prospective members of EMU. Should the Europeans stand back from interventions and the monetary easing necessary for preventing furhter appreciation of their currencies until the more comforting medium-term outlook for much smaller current imbalances is clearly visible to the markets ? Or is some continued depreciation of the dollar warranted both to dampen inflation in Europe and to facilitate a more rapid improvement in the US deficit now that a mild US recession has released the resources for such a swing ?

The dilemma is heightened, if one believes the tendency for on average more fiscal expansion in the EC as member states move closer to monetary unification without having endowed itself with the means to influence unmistakably their own aggregate fiscal policy. Without such means both the traditional public sector deficit countries on the EC and a Germany better protected against individual appreciation than in the past will be tempted to free riding on the future EMU, hence diminishing rather than increasing its potential stabilizing role in the G7 process. This puts fiscal consolidation in the transition phase to EMU and minimum rules for a more permanent framework at the centre of attention at the forthcoming IGC.

Several observers, e.g. Alogoskoufis and Portes (1990) Bergsten (1990) and EC Commission (1990) have pointed out, that a more unified participation in the G7 process on the part of EMU through the President of the ESCB and a political representative, most likely the President in ofice of the Council of Ministers, creates a potential for improved coordination. The only certain gains are, however, that the mutual exchange of information should improve as a result of the greater transparency of a unified monetary policy and that interventions will be simplified when the US and Japanese authorities can deal with only one European monetary authority and in a single currency. Whether gains beyond that will be realized depends on the cohesion of the European representation. Will it be able to put behind diferent levels of ambition in international policy coordination and differences in their degree of aversion to volatility and cycles in exchange rates ? There are several examples from the recent past to illustrate that European divergences of view were at opposite ends in the G7.[5] Judging from the past record, major decisions or statements have been US-inspired, after long periods of passivity. They have been supported and tightened by France and Italy, while Germany and the United Kingdom have been more tolerant of delays in reaction and more reserved about firm policy statements. Given the likely diversity of European positions and the special importance of bilateral relations with Japan, US policy-makers have occassionally tried to reach a prior and more detailed understanding with Japan before initiatives in the G7. And Japan has at times been able to respond with both monetary and fiscal action; higher interest rates to help push the dollar down after the Plaza Agreement and increases in expenditures in early 1987 to reduce her own external surplus while the latter was at its highest.

These, albeit intermittent, examples of bilateral leadership by the United States and Japan could be significantly modified by a more unified European presence. With all three areas coming much closer to having completed external adjustment then at any time since the G7 – or its predecessor up to 1987 the G5 – consultations began all three have a stake in preventing massive imbalances from reemerging. Examples of European initiative – leadership might be an overstatement of what is feasible – would no doubt be welcomed by Japan and possibly by the United States. On the operational side a future ESCB may be better placed than either the Federal Reserve or the Bank of Japan, both subject to political authorization of their respective interventions. (Indeed, the experience of inertia and indecisiveness in the exchange markets of the US and Japanese authorities is, in the view of some European observers, part of the explanation why there appears to be wide support for giving a future ESCB relatively wide discretion to intervene within whatever exchange

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5 An example is the Louvre Accord itself. France had for some time prior to February 1987 advocated a system of target zones with well-defined obligations when a currency went to the band; Germany was only brought around to a looser interpretation where movements beyond (unannounced) bands would trigger consultations, see Funabashi (1988).

rate régime may prevail when it takes over responsibility). On more strategic decisions the influence of the Europeans will depend, as already noted, on their capacity to commit themselves also beyond the monetary area.

Bergsten (1990) notes that a more visibly tripolar system also entails risks. Any one of the three may fear that the two others will "gang up" to force its hand. Though such a possibility could not be excluded in extreme circumstances, no pair of actors would appear to have sufficiently converging interests to make a more permanent coalition likely. The greater risk seems to be, in an environment where the US leverage over the other two has diminished for both economic and security reasons, that each of the three main actors, increasingly confident of being fully in charge of their own economies, disregard signs of tensions with the other two sufficiently long for them to become serious again. This danger is certainly a reality in the European case with the likely preoccupation in the 1990s on regional integration and a widening of the EC. External concerns will seem more remote and responsibility for them too diffuse for effective and early action to be taken.

On issue which the participants in EMU can hardly avoid is the monitoring of the role of a single European currency in the international monetary system. This paper has looked at the tensions in that system mainly from the perspective of longer-run current account imbalances. This may seem too casual and long-term, since exchange rates are, in the shorter term, determined primarily by the willingness of residents in the main countries to hold the outstanding volumes of financial assets denominated in the different currencies. It is only in a long-run perspective that small and clearly sustainable current account imbalances help to stabilize exchange rates. Could not the fairly complacent evaluation of this paper be upset by portfolio shifts between currencies, including the emerging single European currency ?

The framework for analyzing whether international flows are likely to sustain the pattern of small current account imbalances is not well established. The share of the dollar in the portfolio of world net financial wealth held by the non-bank sector across frontiers or in foreign currencies is about one half and declining slowly, while the shares of assets denominated in yen and in EC currencies are rising (Table 3). This gradual diversification is consistent with continuing financing through private financial flows of a modest US current account deficit, since world portfolios continue to grow rapidly. The danger signals lie in a possible acceleration in diversification into non-dollar currencies and, in particular towards the currency of an emerging EMU or, in the transition phase, some of the national currencies which participate in it.

Both the evolution towards EMU and the integration of national financial markets into a European financial area strengthens Europe's position in competition with other major financial centres. Japanese investoers will be increasingly attracted to assets denominated in an emerging single European currency and even US institutional investors may begin to diversify out of their nearly purely dollar-based portfolios. Experiences in the past suggest – with the possible exception of the difficulties in 1987 of maintaining private capital flows to the United States – that portfolio shifts occur relatively slowly and more in response to gradual improvements in the breadth and resilience of financial markets than in search of rapid exchange rate gains. The European currencies' share in the world financial portfolio is not so far from the EC share of OECD income (Table 3) which might set an upper limit to the former. While it is difficult to disagree with the cautious conclusion in EC Commission (1990), that portfolio shifts are unlikely to be seriously disruptive, the outlook is still for some upward pressure on the European currency and some relative rise in European asset prices. This underlines that there will be, also from the capital account, indications of appreciation which could be aggravated if the EMU participants are not prepared to aim for some modest current account deficits in the 1990s and may be beyond, reminiscent of the role played in the world economy of countries that have in the past developed into major international financial centres.

Conclusions.

The main points of this paper are easily summarized:

(1) The major current account imbalances that marked the international economy in the 1980s are finally reduced to modest proportions. Much of the adjustment is due to the working of the price mechanism; in the European case the shft in the savings–investment balance caused by German unification is a stabilizing shock which will eliminate the German surplus and put the EC into deficit.

(2) The completion of the Single Market and progress towards EMU is likely to yield some welfare gains and improvements in Europe's international competitiveness. Some modest trade net diversion is involved which brings the EC current account back towards balance.

(3) The completion of EMU without any mechanisms of mandatory restraints on national budgetary policies would be likely to trigger some collective budgetary expansion, as individual countries are freed of constraints they face to–day. That would imply higher interest rates and possibly accentuate pressures for appreciation in the short to medium–term. A European System of Central Banks is unlikely to have an intervention policy to contain that pressure.

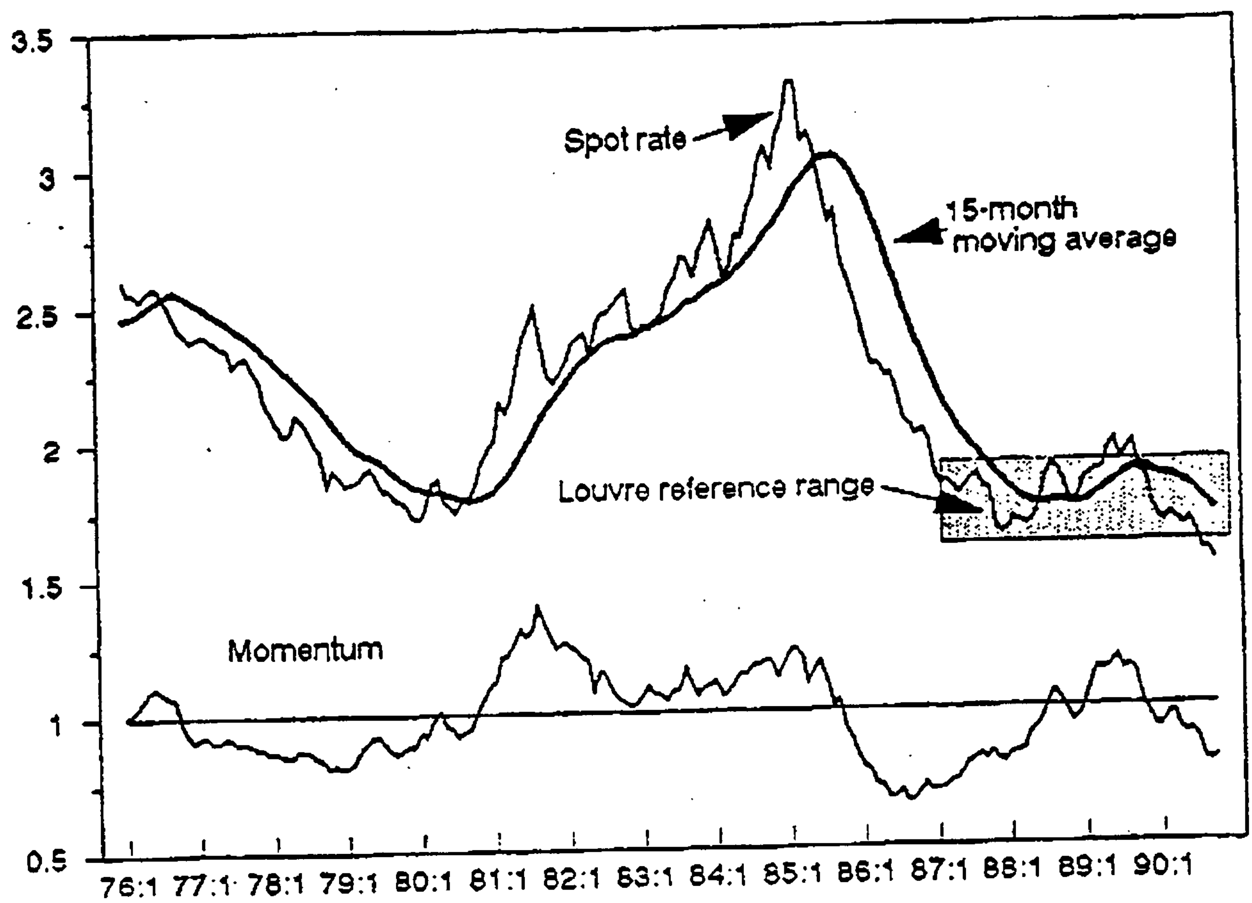
(4) There are potential efficiency gains to international policy coordination, if the number of actors is reduced relative to the present G7. But the gains depend on Europe's capacity to get its own act together and influence its own aggregate fiscal policy.

(5) The evolution of a single currency will strengthen the attractiveness of the European financial area and inward portfolio shifts will moderately reinforce pressures towards appreciation.

Figur 1

Chartism and the DM/$ spot rate

DM per dollar



15-month moving average plotted at latest month
Momentum: ratio of last to first observation included in moving average

Source: Marris (1990), p. 17.

Table 1

External Balances: U.S., Germany and Japan
(billion US dollars)

	United States		Germany		Japan	
	Current Account	Trade	Current Account	Trade	Current Account	Trade
1980	1.1	–25.5.	–13.8	4.9	–10.7	2.1
1981	6.9	–28.0	–3.6	12.3	4.8	20.0
1982	–5.9	–36.4	5.1	21.1	6.9	18.1
1983	–40.1	–67.1	5.3	16.5	20.8	31.5
1984	–99.0	–112.5	9.8	19.0	35.0	44.3
1985	–122.3	–122.1	16.4	24.9	49.2	56.0
1986	–145.4	–145.1	39.5	51.9	85.8	92.8
1987	–162.3	–159.5	45.7	65.5	87.0	96.4
1988	–128.9	–127.0	50.3	72.9	79.6	95.0
1989	–110.0	–114.9	55.3	71.6	57.2	76.9
1990[1)]	–87.0	–97.7	59.8	78.8	41.1	56.2

Sources: US figures from Dept. of Commerce, Survey of Current Business, various Issues; German figures from Monthly Report of the Deutsche Bundesbank, July 1990; Japanese figures from Bank of Japan, Balance of Payments Monthly, June 1990.

1) First half of 1990 at annual rate.

Table 2

Macroeconomic consequences of the Single Market
Per cent change in the medium term

	Real income	Consumer prices	Public deficits	Current account
Frontier controls	0.4	–1.0	0.2	0.2
Public procurement	0.5	–1.4	0.3	0.1
Financial services	1.5	–1.4	1.1	0.3
Supply effects[1)]	2.1	–2.3	0.6	0.4
Total average	4.5	–6.1	2.2	1.0
range	3.2–5.7	–4.5 to –7.7	1.5 to 3.0	0.7 to 1.3

Source: European Economy No. 35, The Economics of 1992, p. 159.

1) Economics of scale (industry) and competition effects (lower monopoly rents and X–inefficiency).

Table 3

Size and currency composition of world financial wealth 1988

	$ bill.	Market share, per cent[1] $	Yen	EC	Other
International bonds	1086	43	12	25	19
Other financial securities	1063		n.a.		
Deposits at foreign banks	964	57	4	29	11
Foreign currency deposits of residents	973	66	5	19	11
World reference portfolio[2], total	4086	50	8	27	15
OECD GNP	14084	34	20	34	12

Source: European Economy No. 44, p. 187.

1) Shares may not add to 100 because of rounding.

2) The reference portfolio is estimated on the basis of BIS data as follows: world external liabilities (= assets) + deposits of residents in foreign currency – interbank assets – direct investment – official international reserved.

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